Change In The UK On The 4th Of July

May 23, 2024

UK general election announced for July 4th

- Opposition Labour Party expected to win a large majority
- Economic improvement likely to have featured behind surprise timing
- Inflation and additional political constraint will preclude June rate cut

Short-term support, medium-term challenges for GBP

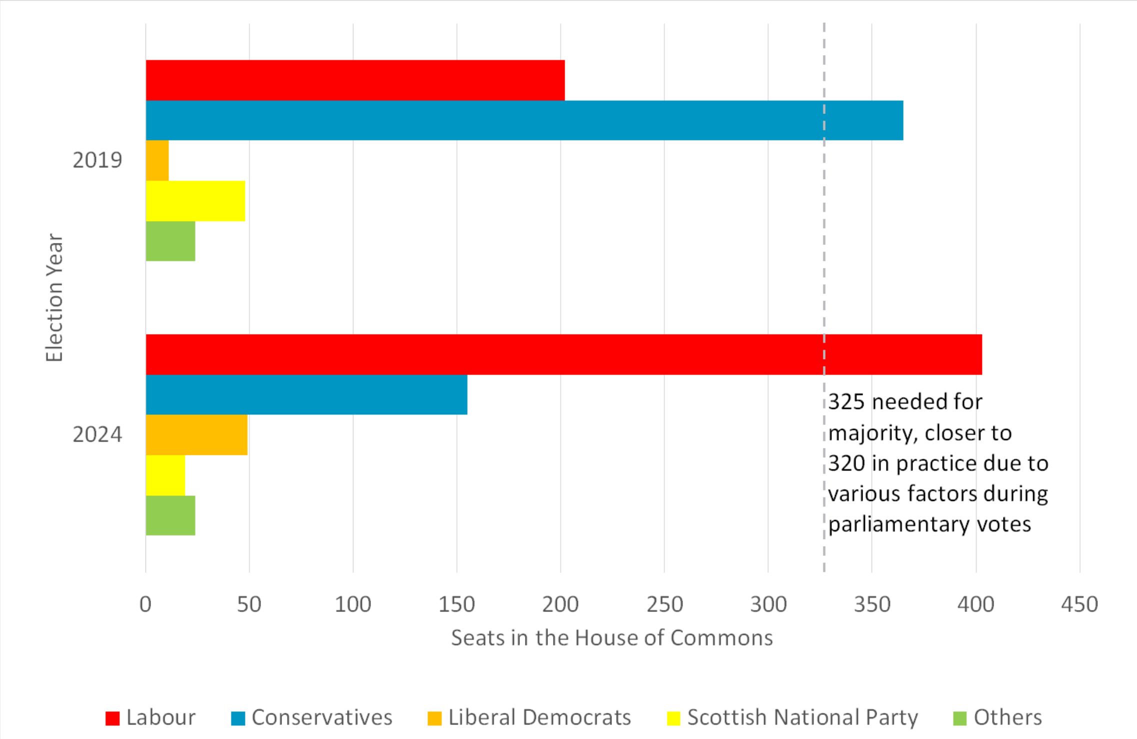
In a surprise announcement, UK Prime Minister Rishi Sunak on Wednesday called a general election to be held on July 4th. The date itself is not particularly auspicious calendrically for the incumbent Conservative Party: Lord North was the prime minister when the United States declared independence from Great Britain on the same date in 1776. At the time, North belonged to 'the Tories', the forerunners of today's Conservative Party.

The timing of a summer vote also comes as a surprise as the Conservatives remain well behind in opinion polling. However, there are clear signs of improvement in economic data, albeit at a slower pace than the prime minister would likely have preferred. Although inflation data released earlier yesterday surprised slightly to the upside, at 2.3% y/y, the figure is well below the extreme levels prevailing when he took office.

Given current polling, it seems hard to argue with the consensus view that this election is the opposition Labour Party's to lose. The last major electoral upset in the UK was in 1992, when the then-incumbent Conservative Party managed to overcome a deficit of 25ppt at one stage to win a slim majority. However, by all accounts the leading parties in that contest were statistically neck-and-neck in polls on the eve of the election.

The latest large multi-level regression and post-stratification (MRP) poll points (exhibit #1) point to a very large Labour victory, with a majority of 154 seats – almost twice the size of the 2019 majority achieved by the Conservatives led by Boris Johnson. There is a chance that the current gap will narrow heading into the election, and boundary changes for electoral constituencies also slightly favour the Conservatives at this election. Even so, our working base case is for a relatively comfortable Labour majority. Under this scenario, the Conservative Party will most likely seek new leadership and a new direction, which will have consequences for UK politics for many electoral cycles to come.

Exhibit #1: Current Polling vs. 2019 Result



Source: YouGov March MRP poll, BNY Mellon

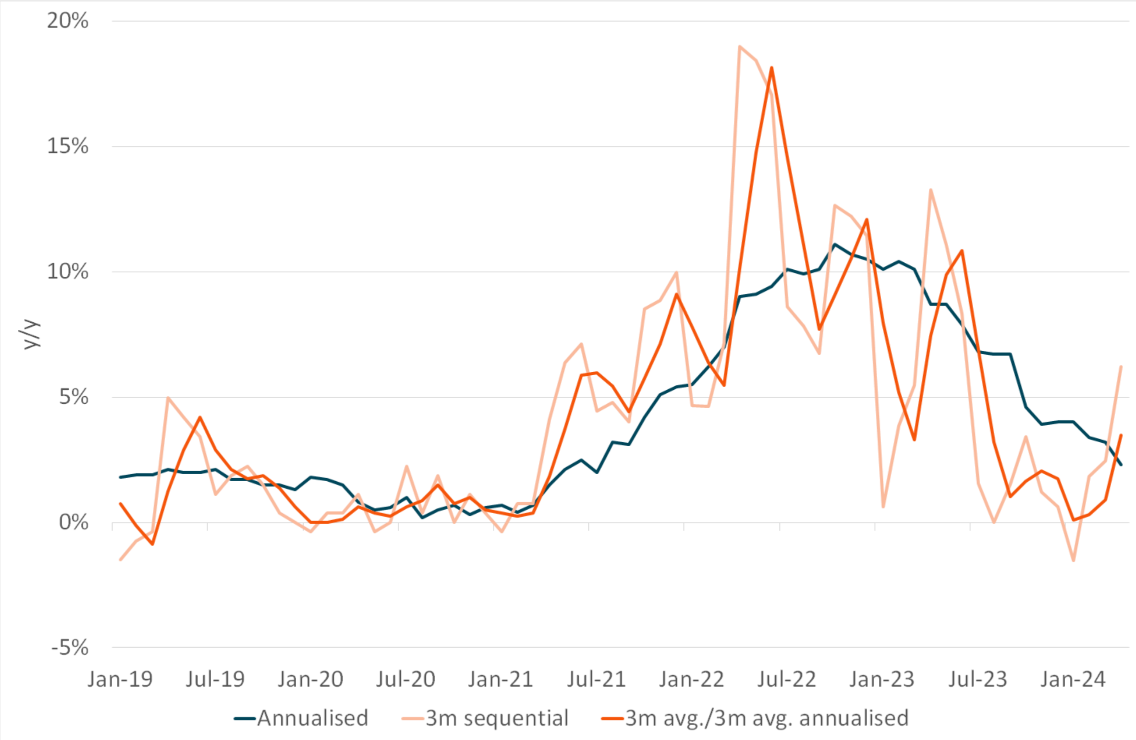
We believe the most immediate impact for the UK economy is that the Bank of England will almost certainly not be able to cut rates at its June 20 meeting, barring a very large downside inflation shock in May, which at present is difficult to envisage. Even before the election announcement, the April inflation figure did surprise to the upside and would likely have kept wavering Monetary Policy Committee (MPC) members on the fence.

On a sequential basis (exhibit #2) we can see that some price momentum is returning; the breakdown of inflation suggests that domestic demand remains robust as discretionary spending components contributed to the positive surprise. As summer months approach and the weather improves, household demand would likely show seasonal strength and keep services inflation well above headline inflation. Coupled with ongoing difficulties with labour supply and participation, the risk to nominal and real wages seems clearly to the upside.

Furthermore, as much as any central bank might wish to profess operational independence, it would not be lost on MPC members that cutting rates two weeks before the election would be extremely sensitive politically. We have expressed similar considerations for the Federal Reserve behind our views on the timing of its rate cut, but at least the FOMC had the luxury of knowing the date of the US presidential election well in advance and could calibrate accordingly. The BoE's MPC, on the other hand, is much more exposed to timings and this will likely weigh on deliberations. It is also not helpful that many Conservative Members of

Parliament (MPs) have openly said that impending rate cuts by the BoE will help build the case for their economic stewardship of the country amid repeated shocks.

Exhibit #2: Sequential Inflation In UK Firming



Source: Bloomberg, BNY Mellon

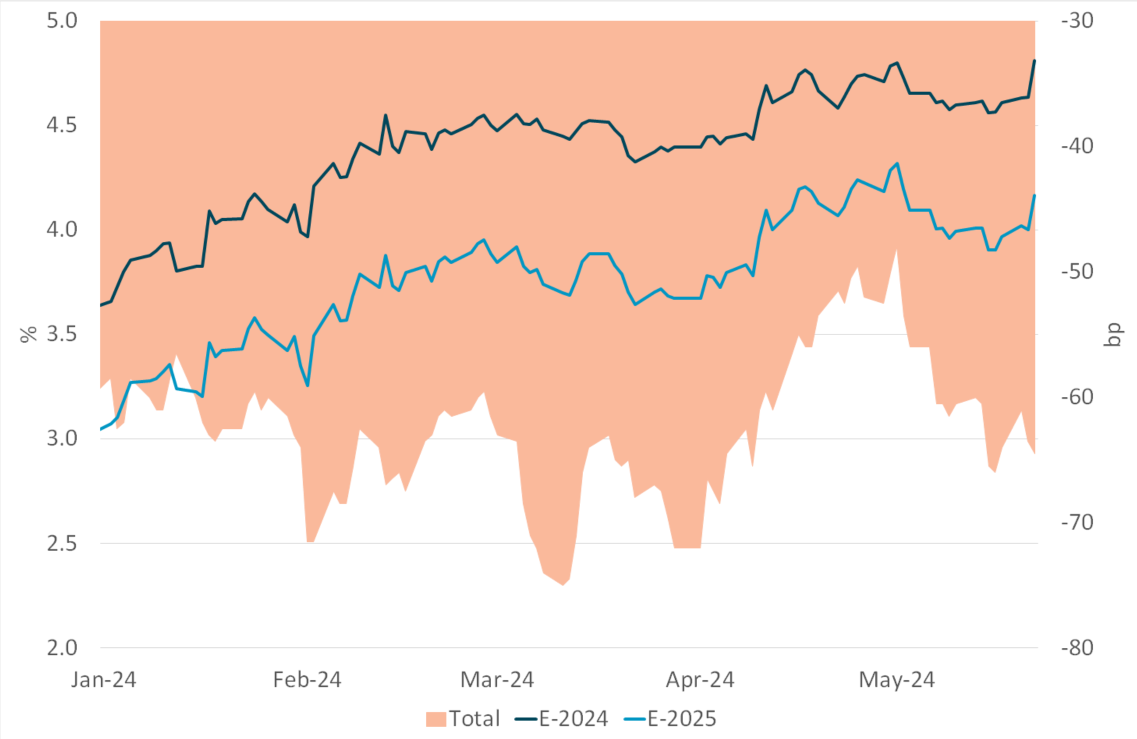
The pound had already reacted positively on Wednesday to UK data and overnight indexed swaps (OIS) had begun to price out two full cuts this year. We believe that even with a very slow trajectory for disinflation, there should be capacity for a follow-up cut in November. A July election would likely be followed by a fresh supply bill in the autumn, the effects of which (in either direction) would unlikely be felt until early 2025. The market now anticipates less than 125bp in easing until the end of next year, with the base rate staying above 4%. In contrast, a base rate of 3% by end-2025 was being priced at the beginning of this year (exhibit #3). This underscores how difficult “the last mile of inflation” has been for developed market economies, and the UK’s particular struggles with stagflation are well documented.

While the Conservative Party will continue to highlight improvement in the economy, the opposition will undoubtedly remind the country of the economic turmoil of 2022 introduced by the previous Conservative Government. Dealing with stagflation in the UK requires material gains to UK productivity, and there will be those in markets who hope that Labour’s instinctive preference for public investment can contribute to the requisite improvements. If real wages remain high due to productivity gains, then the currency can re-rate accordingly.

Unfortunately for those hopers, we believe that public investment is an area where a new Labour Government will most likely disappoint. As the International Monetary Fund (IMF) highlighted in its fresh Article IV assessment of the UK published this week, HM Treasury will require an additional £30bn to stabilise public finances. We believe that this is one of the key reasons behind the prime minister’s decision not to wait until autumn for an election.

Normally, this would mean that another fiscal update, with fiscal incentives for households, will help boost support for the incumbent party ahead of the vote. There had been talk of further cuts to National Insurance, thereby improving cashflow for working households, but clearly the Treasury has come to the conclusion that such ‘giveaways’ are no longer affordable and that it would be better to ride the improvement in the economy now.

Exhibit #3: UK Rate And Easing Pricing

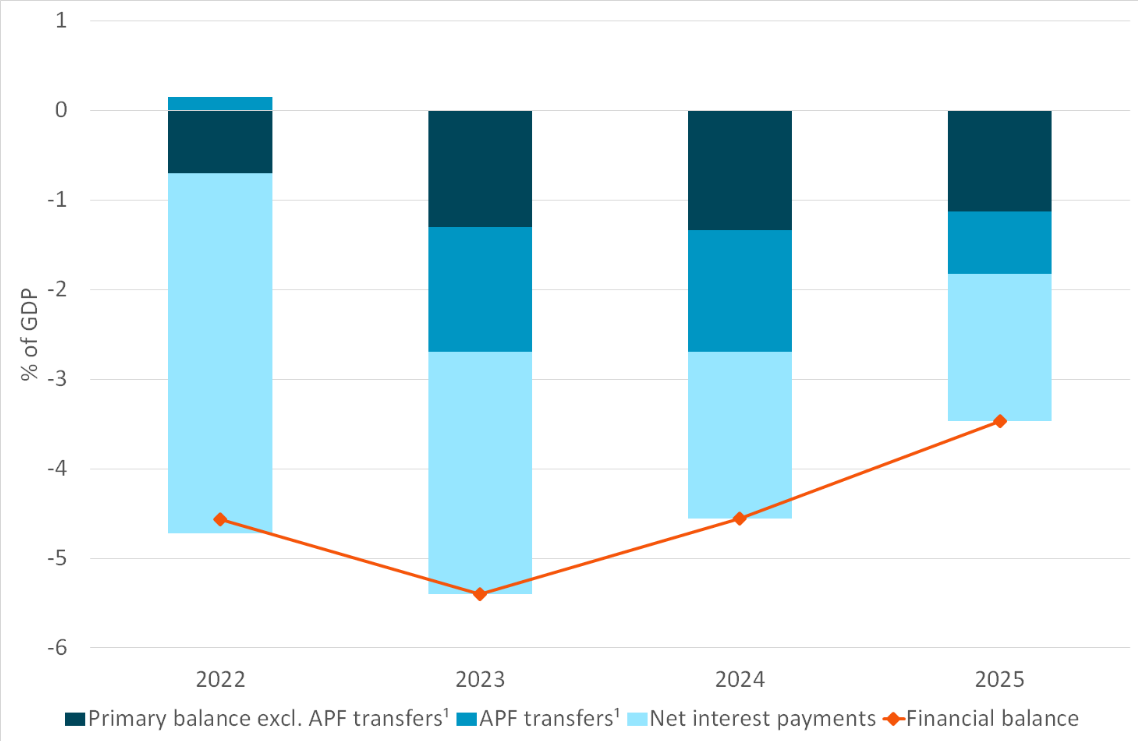


Source: Bloomberg, BNY Mellon

As the OECD’s most recently outlook has highlighted (exhibit #4), up to an additional 8ppt of GDP fiscal adjustment is needed between 2024 and 2025, and that is assuming growth does not surprise to the downside. For the Labour Party, this also means that it will be under heavy fiscal constraints in the first half of the next parliament. Some spending pledges have already been watered down in recent months and the party appears resolute in its efforts to establish an image of economic competence. This also means that productivity gains may also have to wait, and that growth will continue to disappoint.

The silver lining of this process is that fiscal restraint will help bring down inflation faster and the winner of the election will have electoral space to execute restraint. We are already seeing this in New Zealand at present, and not a moment too soon considering the RBNZ’s ongoing concerns about upside inflation risks. With fiscal restraint also comes downside risk to a central bank’s policy trajectory, and the combined result is not a positive outlook for the currency. GBP will likely continue trading well into the election, but re-rating is unlikely over the medium term until public finances are repaired in a credible manner.

Exhibit #4: Expected UK Fiscal Adjustment



Source: Bloomberg, BNY Mellon

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